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A Critical Appraisal of Global Financial Crises 2008-10 and It's Effect on World Economy

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ABSTRACT

Global Economic crises originating in 2008 needs no introduction to all alike. Triggered by the collapse of US mortgage market, it spread like wild fire to all the regions in the world with dire consequences for global trade, investment and growth. Even though five years have passed since the first signs of recession started showing, the magnitude of the above financial tsunami continues to be felt globally. Even more so in Developing countries like India where impending financial reforms & continuous growth have received a setback. Amongst the hue & cry of increased financial regulation & reform of global financial system, there has been weak recovery among markets in developing countries and talks of another recession in euro-zone still persist. This paper closely investigates the causes' of the financial meltdown crises followed by its impact on world economy.

Keywords: Global economic crises, Recession, Inflation, GDP, Per capita growth, Debt default, Credit squeeze, financial reforms.

INTRODUCTION

The Global Financial Crisis (GFC) is the most serious economic crisis since the Great Depression. Despite its severity and its ample effects, the current crisis is similar to past crises in many dimensions. Origins of the Global financial crisis are relatively well known. They lie in the worldwide financial excesses in the past decade; the bursting of housing and oil price bubbles; excessively low interest rate policy scenario ; massive trade surpluses in some countries and huge trade deficits in others; and savings rate that were too low in some parts of the world and too high elsewhere. The cumulative effect was a financial and liquidity crisis that has threatened to become a global macroeconomic upheaval, with significantly negative world GDP growth, perhaps for two or three years, sharply increased unemployment, pressures on public revenues and deflation. Although the crisis

originated in the economies of North America and Europe, its effects were global, with particularly serious implications for the economies of the developing countries. The implication of the crises both in long and short term need to be understood so that markets, forecasters and policy makers do not misunderstand the crisis and can prevent future such 'meltdowns'. The purpose of this paper is to consider the causes and consequences of the crisis and how the financial system should be reformed in terms of institutions and regulations.

REVIEW OF LITERATURE

Bodie *et al*. gave a explanative perspective to the various investments instruments used today's in the financial scenario. This was helpful in understanding the background of the crises. Fabozzi and Modiagliani explain the mechanism of working of High capital fund Institutions. Nirupam Bajpai, Mohan Rakesh & Anand Sinha explain in their insight the various consequences of the crises on India. Ludovico Alcorta & Frederick Nixson explains the various consequences of Global Financial Crises on manufacturing sector worldwide. Gabriel Di Bella gives a great explanation on the effect of Global crises on the Microfinance and Policy Implications. Warwick J McKibbin and Andrew Stoeckel explains the causes of the Global crises, in addition to illustrating the long term and short term consequences of the crises. A Large part of the text was also benefited by the material given from online resources like websites of IMF & RBI and websites of Financial Dailies like economic times etc and also Market Trackers like Dowjones.

What led to economic crises?

In order to understand what led to global recession, we need to go a little back in past and understand what was happening in the housing sector of America for past many years. In US, a boom in the housing sector was driving the economy to a new level. A combination of low interest rates and large inflows of foreign funds helped to create easy credit conditions where it became quite easy for people to take home loans. As more and more people took home loans, the demands for property increased and fueled the home prices further. As there was enough money to lend to potential borrowers, the loan agencies started to widen their loan disbursement reach and relaxed the loan conditions. The loan agents were asked to find more potential home buyers in lieu of huge bonus and incentives. Since it was a good time and property prices were soaring, the only aim of most lending institutions and mortgage firms was to give loans to as many potential customers as possible.

Since almost everybody was driving by the greed factor during that housing boom period, the common sense practice of checking the customer's repaying capacity was also ignored in many cases. As a result, many people with low income & bad credit history or those who come under the NINJA (No Income, No Job, and No Assets) category were given housing loans in disregard to all principles of financial prudence. These types of loans were known as sub-prime loans as those were are not part of prime loan market (as the repaying capacity of the borrowers was doubtful). Since the demands for homes were at an all time high, many homeowners used the increased property value to refinance their homes with lower interest rates and take out second mortgages against the added value (of home) to use the funds for consumer spending. The lending companies also lured the borrowers with attractive loan conditions where for an initial period the interest rates were low (known as adjustable rate mortgage (ARM). However,

despite knowing that the interest rates would increase after an initial period, many sub-prime borrowers opted for them in the hope that as a result of soaring housing prices they would be able to quickly refinance at more favorable terms. The burst of housing boom caused by Overbuilding of houses finally led to a surplus inventory of homes, causing home prices to decline beginning from the summer of 2006. Once housing prices started depreciating in many parts of the U.S., refinancing became more difficult.

Home owners, who were expecting to get a refinance on the basis of increased home prices, found them unable to re-finance and began to default on loans as their loans reset to higher interest rates and payment amounts. In the US, an estimated 8.8 million homeowners – nearly 10.8% of total homeowners – had zero or negative equity as of March 2008, meaning their homes are worth less than their mortgage. This provided an incentive to “walk away” from the home than to pay the mortgage. Foreclosures accelerated in the United States in late 2006. During 2007, nearly 1.3 million U.S. housing properties were subject to foreclosure activity. The sale of new homes dropped by 26.4% in 2007 as compared to 2006. Further, a record nearly four million unsold existing homes were for sale including nearly 2.9 million that were vacant. This excess supply of home inventory placed significant downward pressure on prices. As prices declined, more homeowners were at risk of default and foreclosure. Had it remained a matter between the lenders (who disbursed risky loans) and unreliable borrowers (who took loans and then got defaulted) then probably it would remained a local problem of US. But it was not the case.

How the crises spread

Let us understand what complicated the problem. For original lenders these subprime loans were very lucrative part of their investment portfolio as they were expected to yield a very high return in view of the increasing home prices. Since, the interest rate charged on subprime loans was about 2% higher than the interest on prime loans (owing to their risky nature); lenders were confident that they would get a handsome return on their investment. In case a sub-prime borrower continued to pay his loans installment, the lender would get higher interest on the loans. And in case a sub-prime borrower could not pay his loan and defaulted, the lender would have the option to sell his home (on a high market price) and recovered his loan amount. In both the situations the Sub-prime loans were excellent investment options as long as the housing market was booming. Just at this point, the things started complicating. With stock markets booming and the system flush with liquidity, many big fund investors like hedge funds and mutual funds saw subprime loan portfolios as attractive investment opportunities. Hence, they bought such portfolios from the original lenders. This in turn meant the lenders had fresh funds to lend. The subprime loan market thus became a fast growing segment. Major (American and European) investment banks and institutions heavily bought these loans (known as Mortgage Backed Securities, MBS) to diversify their investment portfolios.

Most of these loans were brought as parts of CDOs (Collateralized Debt Obligations). CDOs are just like mutual funds with two significant differences. First unlike mutual funds, in CDOs all investors do not assume the risk equally and each participatory group has different risk profiles. Secondly, in contrast to mutual funds which normally buy shares and bonds, CDOs usually buy securities that are backed by loans (just like the MBS of subprime loans).

Owing to heavy buying of Mortgage Backed Securities (MBS) of subprime loans by major American and European Banks, the

problem, which was to remain within the confines of US propagated into the world's financial markets. Ideally, the MBS were a very attractive option as long as home prices were soaring in US. However, when the home prices started declining, the attractive investments in Subprime loans become risky and unprofitable. As the home prices started declining in the US, sub-prime borrowers found themselves in a messy situation. Their house prices were decreasing and the loan interest on these houses was soaring. As they could not manage a second mortgage on their home, it became very difficult for them to pay the higher interest rate. As a result many of them opted to default on their home loans and vacated the house. However, as the home prices were falling rapidly, the lending companies, which were hoping to sell them and recover the loan amount, found them in a situation where loan amount exceeded the total cost of the house. Eventually, there remained no option but to write off losses on these loans. The problem got worsened as the Mortgage Backed Securities (MBS), which by that time had become parts of CDOs of giant investments banks of US & Europe, lost their value. Falling prices of CDOs dented banks' investment portfolios and these losses destroyed banks' capital.

The complexity of these instruments and their wide spread to major International banks created a situation where no one was too sure either about how big these losses were or which banks had been hit the hardest.

The effects of these losses on global banks were huge. Global banks and brokerages have had to write off an estimated $512 billion in subprime losses so far, with the largest hits taken by Citigroup ($55.1 billion) and Merrill Lynch ($52.2 billion). A little over half of these losses, or $260 billion, have been suffered by US-based firms, $227 billion by European firms and a relatively modest $24 billion by Asian ones.

Despite efforts by the US Federal Reserve to offer some financial assistance to the beleaguered financial sector, it has led to the collapse of Bear Sterns, one of the world's largest investment banks and securities trading firm. Bear Sterns was bought out by JP Morgan Chase with some help from the US Federal Bank. The crisis has also seen Lehman Brothers – the fourth largest investment bank in the US and the one which had survived every major upheaval for the past 158 years – file for bankruptcy. Merrill Lynch has been bought out by Bank of America. Freddie Mac and Fannie Mae, two giant mortgage companies of US, have effectively been nationalized to prevent them from going under. Reports suggest that insurance major AIG (American Insurance Group) is also under severe pressure and has so far taken over $82.9 billion so far to tide over the crisis.

From this point, a chain reaction of panic started. Since banks and other financial institutes are like backbone for other major industries and provide them with investment capital and loans, a loss in the net capital of banks meant a serious detriment in their capacity to disburse loans for various businesses and industries. This presented a serious cash crunch situation for companies who needed cash for performing their business activities.

Now it became extremely difficult for them to raise money from banks. What was worse is the fact that the losses suffered by banks in the subprime mess have directly affected their money market the world over. Money Market is actually an inter-bank market where banks borrow and lend money among them to meet short-term need for funds. Banks usually never hold the exact amount of cash that they need to disburse as credit. The 'inter-bank' market performs this critical role of bringing cash-surplus and cash-deficit banks together and lubricates the process of credit

delivery to companies (for working capital and capacity creation) and consumers (for buying cars, white goods etc).

As the housing loan crisis intensified, banks grew increasingly suspicious about each other's solvency and ability to honor commitments. The inter-bank market shrank as a result and this began to hurt the flow of funds to the 'real' economy. Panic begets panic and as the loan market went into a tailspin, it sucked other markets into its centrifuge. As seen below in the graph 2008-2009 recorded a huge loss in investor confidence.

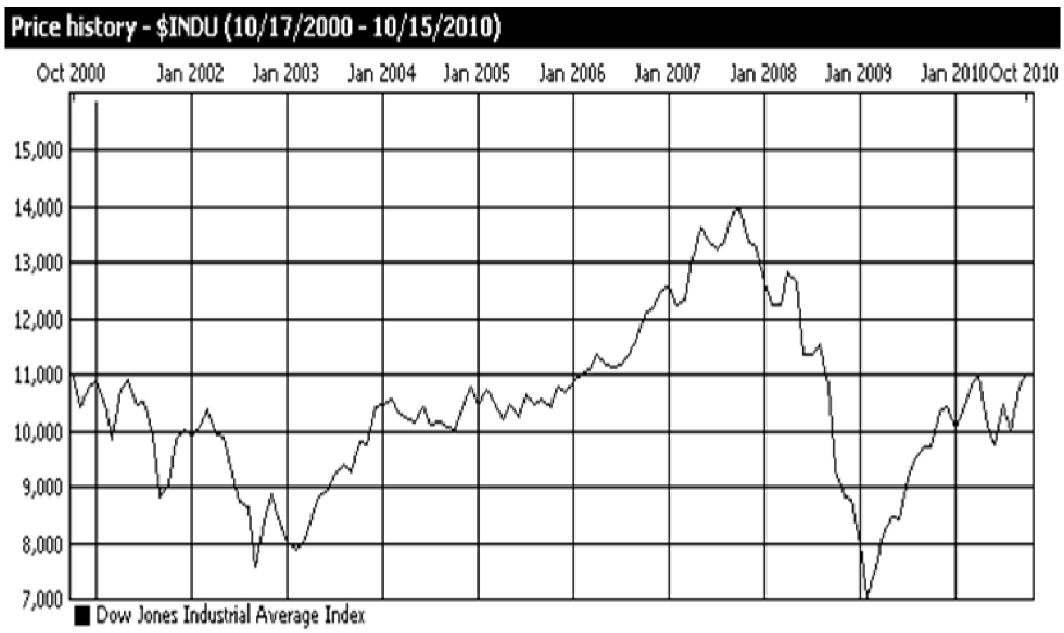

Fig (1) Dow Jones Index 2000-2010 – Source www.new.dowjones.com

The liquidity crunch in the banks resulted in a tight situation where it has become extremely difficult even for top companies to take loans for their needs. A sense of disbelief and extreme precaution was prevailing in the banking sectors. The global investment community has become extremely risk-averse. They were pulling out of assets that are even remotely considered risky and buying things traditionally considered safe-gold, government bonds and bank deposits (in banks that are still considered solvent).As such financial crisis was the culmination of the above mentioned problems in the global banking system. Inter-bank markets across the world were frozen over.

The meltdown in stock markets across the world was a victim of this contagion. At its worst in December 2008 Governments and central banks (like Fed in US) were trying every trick in the book to stabilize the markets. They had pumped hundreds of billions of dollars into their money markets to try and unfreeze their inter-bank and credit markets. Large financial entities were nationalized. The US government has set aside $700 billion to buy the 'toxic' assets like CDOs that sparked off the crisis. Central banks had got together to co-ordinate cuts in interest rates.

Effect on World & Indian Economy

As we have mentioned earlier, the global financial crisis has affected virtually all areas, including the process of globalization.

1. Housing prices crashed & Real estate sector doomed in Developed Countries especially US & Europe; plunging real estate prices affected virtually all areas of the economy. People could no longer afford to purchase homes, which meant that homebuilders were forced to abandon construction projects.
   Think of all the products that are used in building and furnishing a home; all of the industries that produced these products generally experienced declining sales. Because houses became primary sources of wealth or perceptions of wealth, falling real estate prices made homeowners feel less economically secure. In a vicious circle, the economic recession, fueled by declining real estate markets, further eroded demand for real estate.
2. Bankruptcy & foreclosures became commonplace; Companies stopped Hiring and employee firing became a ritual in many companies to prevent a closure. HR related issues became a norm in the general buzz of economy worldwide became depression laden. The mortgage crisis inevitably spread to financial institutions, causing reputable Wall Street firms such as Lehman Brothers to collapse overnight. Because of Lehman's pivotal role in finance, its demise in September 2008 is generally perceived as the most tangible evidence of the financial crisis on Wall Street. Iceland, which had a very successful banking system, saw its economy and currency collapse along with the banking system.
3. Manufacturing & Production declined sharply, especially in the automotive industry; Industrial Production collapsed. Over all GDP growth came down and led to massive depletion across continents. This especially was the case in the automotive industry, with General Motors and Chrysler declaring bankruptcy after closing many factories and dealerships, despite unprecedented financial support from the U.S. government. Industrial production was down by 12 percent in Europe, 11 percent in the United States. Tightening credit and consumer fear ultimately created a downward spiral that significantly diminished global trade. Germany saw its exports drop by 20 percent. China's exports fell by more than 25 percent, and U.S. exports fell by almost 24 percent in 2008.

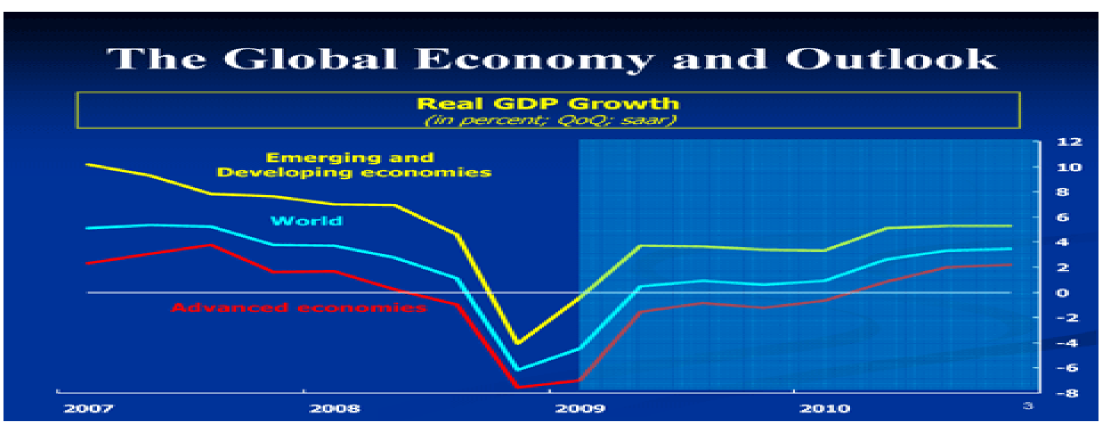

Fig (2) Real GDP Growth for the world Source:- www.imf.org

4. On the other hand, many developing countries that took a prudent approach to finance and saved money were not as badly damaged. In fact, countries that did not fully embrace financial liberalization were less affected than those that gave in to American pressure to fully engage in financial globalization. We also saw a global power shift, with the United States losing ground to China, India, Brazil, and other developing countries. Although most countries were negatively affected by the financial crisis and global recession, some emerged stronger than others. Brazil, Russia, India, and China, also known as the BRIC countries, enhanced their power vis-à-vis the United States, Western Europe, and Japan. Within the EU, Germany emerged with the strongest financial and economic system and greater political and economic power. In sharp contrast to the policies adopted by the U.S. Federal Reserve the Reserve Bank of India, rejected many financial innovations and limited the participation of foreign investors in India's financial system. Instead of believing that markets are self-regulating, as many Americans do, the Indian government favoured regulations and was quick to recognize financial bubbles. Reddy restricted bank lending to real estate developers, increased the amount of money banks had to set aside as reserves, and blocked the use of some derivatives. This conservative approach enabled India to largely avoid the global financial crisis.
5. Unemployment rate reached 10 percent in the United States and higher levels in Europe and elsewhere; The global economic crisis that began in 2007-2008 has had a huge effect on the number of unemployed people around the world, which, according to International Labour Organization (ILO) estimates, increased from 178 million in 2007 to 197 million in 2012, with a peak of 212 million reached in 2009.

Unfortunately, prospects for future 2013 & 2014 remain bleak, with the world's unemployment rate again on the rise. "An uncertain economic outlook, and the inadequacy of policy to counter this, has weakened aggregate demand, holding back investment and hiring," said Director-General Guy Ryder presenting the ILO Global Employment Trends 2013 report. "This has prolonged the labor market slump in many countries, lowering job creation and increasing unemployment duration."

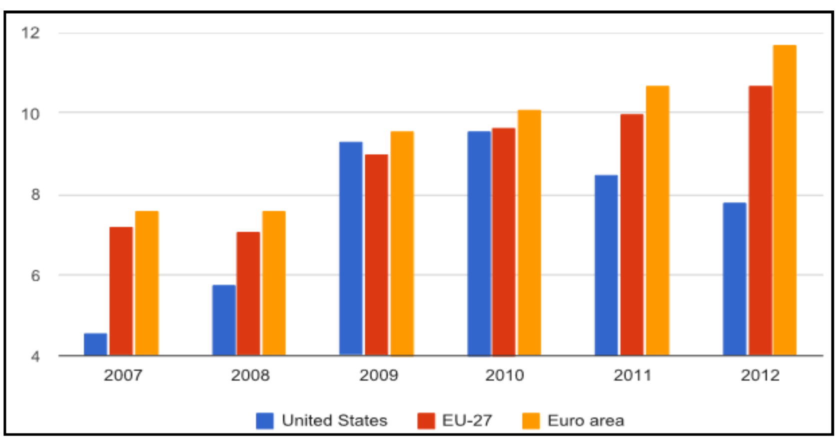

Fig (3) Total Unemployment during the Great Recession Source: Euro stat, Feb 2013

CONCLUSION

Lessons from economic recession

The health of the global economy had started deteriorating even at the beginning of the century without anybody noticing it. Or was it ignored deliberately? Some may call it deliberate. While stepping into the new century, expectations were peaking. Multi National Companies were busy creating new business opportunities. Unrealistic pay packets were created and offered to even neophytes to generate competition among these companies. Fresher's used these opportunities like spring boards to take longer leaps keeping in mind only the weight of the pay packets. Millions hankered after these pseudo creations and pocketed hefty pay packets for quite some time unaware of the reality. The mall culture brought expensive trivial items and luxury junks to households ousting the indigenous counterparts. Hollow novelty replaced utility. As people dug deeper into their pockets unabashed the economy rose higher into the skies. Or so they thought. At that time it was absurd to assume that millions of people world over would pay for it sometime later.

Hence what started was a downward spiral which brought down with it not only the health of the companies but also the millions of dreams that had skimmed along the fringes of the former. It was a staggering U-turn as the losses made so far were irrecoverable. The total impact was unfathomable. Any exercise for fathoming the complete impact will be a wasteful exercise at this stage since it had made damage to that extent world over which had a cascading effect on almost everything. In a chain reaction manner it affected each and every walk of life and the so perceived booming strongholds of economy came down like a pack of cards. During the last few decades of economic reforms, poverty has come down definitely, but too slowly which has raised serious doubts about whether market reforms by globalization alone could eliminate poverty and unemployment. A well-established company under strong governance for instance, the emblem of the new technological age of information technology had contributed a great extent to generate jobs for the top three percent or so graduates. But what it did for the larger masses?

The making and implementation of a strong economic policy is not child's play. Increasing economic growth in larger terms should not be the sole objective of the society. In the face of the competition from foreign markets, domestic markets should not be left to frail away. Lest the result will be catastrophic to the tune of the disaster we are reeling under today. It was a lesson learnt the hard way. We should concentrate and analyze the failure of economic reforms globally to be able to put a finger on the exact causes leading up the recession.

Increased & Broad based financial regulation & enhanced supervision , Protection to retail investors for frauds & defaults , aligning the societal & economic viewpoints, promoting a balanced public private partnership route for balanced growth are some means by which the governments across the world can and are negating the possibilities of future such disasters.

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